Office for National Statistics

Article

Coronavirus and the effects on the UK Institutional Sector Accounts

How the global coronavirus (COVID-19) pandemic and the wider containment efforts are expected to impact on UK Institutional Sector Accounts as well as some of the challenges that National Statistical Institutes are likely to face.

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1 . Overview

Recent external published forecasts project that the coronavirus (COVID-19)[1] pandemic will cause a contraction in the UK and global economy this year larger than that experienced following the 2008 global financial crisis. The UK National Accounts provide a coherent framework to assess the implications of this contraction and the associated policy response, including for the non-financial and financial transactions that are recorded in the Institutional Sector Accounts. The aim is to explain how we expect the response to COVID-19 to affect estimates of the Institutional Sector Accounts for:

- households
- non-profit institutions serving households[2]
- non-financial corporations
- financial corporations
- the government

This is the latest article that explains how COVID-19 will affect the production of the UK National Accounts, including estimates of gross domestic product (GDP) and the UK Balance of Payments. We have also published material on how COVID-19 might affect our estimates of inflation, the labour market and productivity and public sector finances. Taken together, these provide a holistic picture of the potential impact of COVID-19 on the UK economy, and the practical effects of how we measure it.

Notes for: Overview

1. The first case of the coronavirus (COVID-19) was reported to the World Health Organization (WHO) in December 2019 and was subsequently declared a public health emergency of international concern (PHEIC).
2. For ease, we do not explicitly refer to non-profit institutions serving households (NPISH) elsewhere here.

2 . How the UK Institutional Sector Accounts are compiled

The UK Institutional Sector Accounts provide a conceptual framework using a sequence of accounts that show the transactions and positions of the following in the UK:

- households
- non-profit institutions serving households
- non-financial corporations
- financial corporations
- the government

This also shows the relationship that the UK has with the rest of the world, including the extent to which the UK is a lender or borrower[1] . These estimates help explain the functioning and interaction of the different agents in the economy and how important economic indicators in the UK might be impacted, including the saving ratio, the level of household and corporate debt and the sectoral net lending or borrowing positions.

There are three main features to the framework:

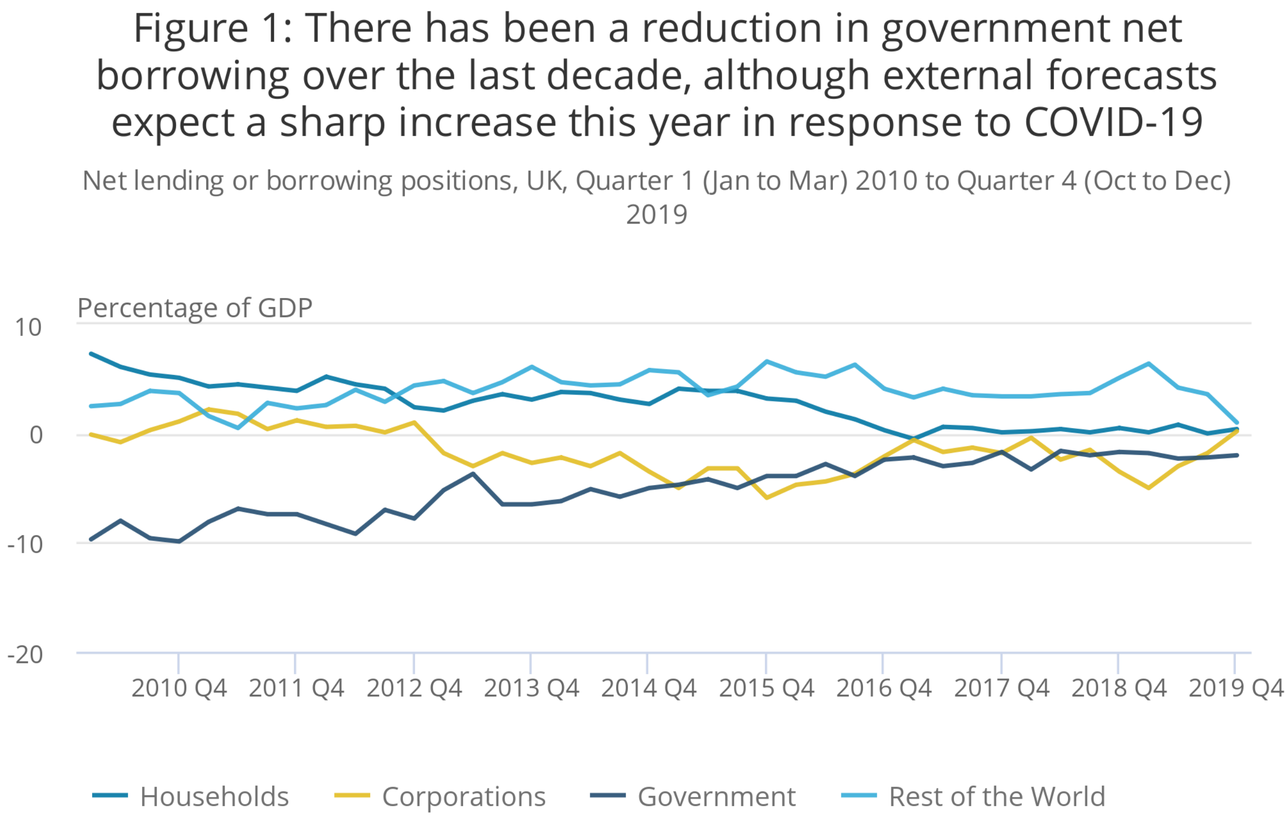
- non-financial transactions: these are transactions that relate to production, income, consumption and capital investment
- financial transactions: these gross transactions capture the change of ownership in financial claims that culminate in net lending or net borrowing
- balance sheets: these stock positions record the value of non-financial assets, financial assets and liabilities owned at the start and end of a reference period; the start and end period stock levels are reconciled by flows – that is, transactions, revaluation effects and other changes in the volume of assets

All types of spending – consumption expenditure, gross capital formation and capital transfers – relative to disposable income determine whether households, corporations and government are a net lender or net borrower. Those institutional sectors that have expenditure lower than disposable income are net lenders, while those that have expenditure exceeding disposable income are net borrowers. These positions are among the main economic indicators identified in this framework.

Previous analysis has explained how the economy would likely be affected by the coronavirus (COVID-19), including looking at the paths of income and expenditure. The paths of income and expenditure of the domestic sectors of the UK in relation to the rest of the world determine whether the UK is a net lender to or borrower from the rest of the world[1] . Given that total borrowing must be matched by total lending, the net positions across all the sectors must sum to zero in any period (Figure 1).

Figure 1: There has been a reduction in government net borrowing over the last decade, although external forecasts expect a sharp increase this year in response to COVID-19

Net lending or borrowing positions, UK, Quarter 1 (Jan to Mar) 2010 to Quarter 4 (Oct to Dec) 2019



Source: Office for National Statistics

Notes:

1. Households include non-profit institutions serving households.

2. The official estimates of the Public sector finances typically provide more up-to-date version of government net borrowing. The revisions policies for the UK national accounts and the Public sector finances are not the same, as the former are revised less frequently because of their added complexity and integrated nature. Further information is available on the alignment between the Public sector finances and national accounts.

3. These positions may not sum to zero because of rounding.

Notes for: How the UK Institutional Sector Accounts are compiled

1. This is also recorded in the UK Balance of Payments, which is consistent with the UK National Accounts.

3 . Understanding the economic and financial effects of the coronavirus (COVID-19)

Recent external published forecasts project a contraction in the UK and global economy this year that would be larger than that experienced in the 2008 global financial crisis. For example, the International Monetary Fund (IMF) forecasts a fall of 3.0% in the global economy this year. This reflects how "infections reduce labour supply", how "quarantines, regional lockdowns, and social distancing ... curtail mobility" and the fact that "workplace closures disrupt supply chains and lower productivity". It also highlights the effects of "layoffs, income declines, fear of contagion, and heightened uncertainty". The effects of the coronavirus (COVID-19) pandemic are also highlighted by the Bank of England and the Office for Budget Responsibility[1], while the initial official estimates that have been published so far show an unprecedented fall in UK gross domestic product (GDP).

We look at the anticipated economic impacts of the coronavirus (COVID-19) on the UK through the framework of the UK Institutional Sector Accounts. This is to explain how these effects on the gross and net transactions would be recorded. As such, these are not to be considered as forecasts but rather as illustrative examples, particularly as there will be much uncertainty around how this may play out in practice. We will provide a more informed picture of the effects when these are published.

Some examples of those non-financial transactions that might be affected are included in this section.

Wages and Salaries

Higher levels of slack in the labour market contribute to lower compensation of employees if there is a fall in the levels of employment, hours worked, or wage rates. Such developments will lead to an adverse impact on the household financial position, although the government furlough scheme is expected to limit the effect on employment (see below).

Profits

Gross operating surplus for non-financial corporations will likely reduce given the fall in output sold in response to COVID-19, likely leading to an increase in borrowing. This will have a negative impact upon the net lending or borrowing position of non-financial corporations, all else the same. Likewise, there would be a fall in mixed income if public health restrictions have an adverse effect on the ability of the self-employed to undertake economic production[2]. Any adverse impacts on working capital of those adversely impacted businesses might have led to an increase in their borrowing requirements.

Investment Income

Income from equity investment that shareholders receive might have fallen, reflecting a decline in corporation's profits and/or the firm’s choice to make fewer dividend payments to build up capital to increase financial resilience. It is also possible that the income on debt investment will be affected, through lower interest rates, and possibly increased holdings as investors move into less risky assets. There may also be some impacts from other movements in financial markets. This would impact upon the net lending or borrowing positions of the counterparties involved in those equity and debt investments.

Fiscal

The contraction of the economy will reduce tax receipts, while the fiscal policy response will increase government expenditures. These effects will increase government borrowing.

The recent changes to Universal Credit are a form of cash transfers from the government, specifically social assistance benefits, so to meet the financial needs of households in case of unexpected events such as COVID-19. These welfare payments will improve the financial position of households, although the overall impact on household disposable income also needs to consider other transactions such as compensation of employees and mixed income.

Government schemes that provide support for businesses will be recorded as subsidies [3] that improve the financial position of non-financial corporations. Some provide support directly from central government and devolved administrations, while other funding is distributed by local authorities.

Households’ consumption and saving

There has been a reduction in households’ consumption expenditure, particularly in those products considered non-essential and those services that require face-to-face contact between consumers and businesses. There has been anecdotal evidence of a change in the timing and composition of household consumption amidst concerns of the effects of COVID-19 on the economy.

The decline in consumption may also reflect an increased level of precautionary household saving, reflecting the higher levels of uncertainty and/or lower levels of confidence. There may also be an impact on the property market, which would likely affect the level of household investment to be carried out. All else the same, this would lead to an improved financial position for households.

Capital expenditure and inventories

Given the uncertain climate created by the pandemic, the introduction of physical restrictions, and the decline in economic activity, businesses may be expected to reduce their capital expenditure and cancel existing orders. There may be some initial building up of certain types of inventories by businesses amid concerns of restrictions on the international movement of goods, though there may be a process of de-stocking or write-offs later in the year.

A fall in gross capital formation would reduce the need to borrow or access cash reserves and may have led to increased level of precautionary saving for those non-financial corporations that continue to operate.

Net borrowing and net lending positions

A net borrowing position must be funded by taking on further financial liabilities and/or reducing financial assets, while a net lending position is reflected in a net increase in financial assets and/or decrease in financial liabilities [4] .

However, irrespective of net financing needs, there may also be an impact on gross transactions. These include flows of household and corporate credit through financial intermediaries, such as:

- loans
- debt and equity financing by UK and foreign investors
- increases in the volume of deposits held in financial intermediaries if there is a rise in precautionary saving
- the extension of trade credit for postponed or cancelled activities
- increases in the purchases of government gilt

These movements will reflect the demand and supply for finance, as well as the impact of specific policy interventions.

Notes for: Understanding the economic and financial effects of the coronavirus (COVID-19)

1. The Bank of England has produced a scenario in which the UK economy contracts by 25% in the second quarter (April to June) of this year. The Office for Budget Responsibility has produced a reference scenario in which real gross domestic product (GDP) falls by 35% in the same period.

2. Non-financial transactions include those that affect production, income and expenditure transactions, which are covered in Coronavirus and the effects on UK GDP .

3. The terms subsidy, grant, and transfer have specific definitions in the UK National Accounts. These can sometimes be used interchangeably in other contexts.

4. Revaluations and other changes in volume need to be considered in understanding the stock position, as financial balance sheets do not only reflect changes in financial transactions.

4 . Recording of fiscal and monetary policies

Since the start of the coronavirus (COVID-19) pandemic, there has been a large fiscal and monetary policy package implemented in the UK that looks to provide financial support to the economy. These include loans, subsidies, grants and tax deferrals to businesses, as well as an increase in welfare payments to households. In response to COVID-19, the Bank of England increased its asset purchases by an initial £200 billion. An additional £100 billion in its Asset Purchase Facility has since been announced.

The introduction of the Coronavirus Job Retention Scheme helps businesses retain employees, which in turn benefits households. The flow of credit has also been facilitated by a reduction in the Bank Rate, additional quantitative easing, the expansion of the Term Funding Scheme, and a reduction in the countercyclical capital buffer[1].

As a consequence, there will be a significant increase in public sector net borrowing (PSNB) [2], which in large part will be financed by an increase in the issuance of gilts by the Debt Management Office (DMO). There will be an expansion of the balance sheets of the central bank and financial institutions. Alternatively, it might be that foreign investors will finance this additional borrowing. It might also be that this is financed by households and/or corporations, which might reflect the increase in precautionary household and corporate saving. This may also be reflected by an increase in private debt.

We look at some of the major policy interventions to show how these will be reflected in the recording of non-financial and financial transactions. We do not offer any views on what the individual impacts in the Institutional Sector Accounts might be. These are not to be considered as forecasts but rather as an explainer of the Institutional Sector Accounts framework. We will provide a more informed picture of the impacts when these are published.

Loan guarantee schemes

The UK government has introduced loan guarantees to facilitate the flow of credit from financial corporations to private non-financial corporations (PNFCs). While the borrower remains liable for the full value of the loan, the government guarantee protects lenders from any losses arising from the insolvency of that borrower [3].

The Coronavirus Business Interruption Loan Scheme (CBILS) is aimed at small- and medium-sized enterprises. This provides the lender a government-backed guarantee for the loan repayments, where a lender can provide up to £5 million in loans and overdrafts. This partial guarantee is against the outstanding balance of the finance. A Business Interruption Payment covers the first 12 months of interest payments and any lender-levied charges.

The Coronavirus Large Business Interruption Loans Scheme (CLBILS) provides financial support to large firms. These loans are up to £50 million, depending on the business turnover. This gives the lender a government-backed partial guarantee against the outstanding balance of the facility.

The Bounce Bank Loan Scheme (BBLS) for small- and medium-sized enterprises, providing the lender with a full government-backed guarantee against the outstanding balance of the finance. These loans range from £2,000 up to 25% of a business' turnover. The maximum loan amount is £50,000. A Business Interruption Payment (BIP) covers the first 12 months of interest payments.

These loans will be recorded as a financial asset for financial corporations and a financial liability for PNFCs. The CBILS and CLBILS loan guarantees are considered as standardised guarantees. This means that a provision for calls will be recorded as a liability on the government balance sheet and an asset on the PNFC balance sheet. Government borrowing will be increased and PNFC borrowing decreased by the value of an imputed capital transfer intended to reflect the expected amount the government will need to pay for guarantees called. Payments made by government to cover the costs of interest during the first year are considered as subsidies on production and will increase government borrowing.

Because of the complexities of these loan schemes, we have not yet determined when the classification as standardised guarantees will be fully reflected in the UK Institutional Sector Accounts. We have not yet determined the treatment of the BBLS.

Term Funding Scheme

The expansion of the Term Funding Scheme aims to incentivise the provision of credit to businesses and households, particularly small- and medium-sized enterprises. It helps reinforce the transmission of the reduction in Bank Rate to the economy. Eligible financial intermediaries have access to four-year funding at rates very close to Bank Rate, up to 10% of their stock of lending, with scope for additional borrowing based on the volume of lending to households and businesses.

This credit extension would be reflected initially in increased borrowing and lending by financial corporations, including an expansion of the Bank of England's balance sheet. As financial institutions lend the funds borrowed to businesses and households, this provision of credit would be recorded as financial assets for the former and financial liabilities for the latter.

Debt financing

The COVID Corporate Financing Facility (CCFF) is a facility backed by HM Treasury, and operated by the Bank of England on their behalf. Through the purchase of commercial paper debt issued by private non-financial corporations and their finance subsidiaries, the facility aims to provide working capital for larger businesses that are experiencing temporary disruption to their cash flows and balance sheet positions. The scheme is also intended to support corporate finance markets overall.

We will record purchases of commercial paper through the CCFF in the financial account as an asset of central government and a liability for PNFCs and financial corporations. As the purchase of commercial paper by the CCFF will be financed via the Bank of England issuing additional central bank reserves, there will also be an increase in the liability of Central Government and in the assets of the Bank of England. Given that the commercial paper is a debt investment, interest will be received by the central government and paid by PNFCs.

Asset purchases

Quantitative easing involves the purchasing of government and corporate bonds by the Bank of England, in which money is injected into the economy so as to provide an additional stimulus to nominal spending . As these purchases are financed by new central bank reserves, it increases the amount of central bank money held by banks as well as the amount of deposits held by firms and households that previously owned those assets. In response to COVID-19, the Bank of England increased its asset purchases by a further £200 billion. An additional £100 billion in its Asset Purchase Facility has since been announced.

These purchases increase the stock of government bonds and corporate bonds owned by the Bank of England with corresponding reductions in holdings by those sectors that previously owned the bonds purchased under the scheme. As the purchases are financed by new central bank reserves, it increases the amount of central bank money held by banks as well as the amount of deposits held by firms and households who previously owned those assets. This will also be corresponding changes in recorded investment income transactions.

Job retention schemes

The UK government has implemented the Coronavirus Job Retention Scheme (CJRS) and the Self-Employment Income Support Scheme (SEISS). The aim of the CJRS is to support employers maintaining their business through this period and keeping their employees on the payroll, facilitating a quick return to production as lockdown conditions are eased. The SEISS provides government support to the self-employed for their business operations, providing a direct cash payment[5].

Previous analysis has highlighted how we have taken an interim view, reflecting the latest international position that CJRS payments are recorded as other subsidies on production from the government to the employer and payments of remuneration by employer to employees as wages and salaries. SEISS payments are to be recorded as other subsidies on production from the government to the self-employed and subsequently treated as mixed income. In both instances, the offset in other subsidies on production implies no net impact on gross value added.

Deferral of tax payments

Tax holidays have been introduced to ease liquidity constraints over the coming months. For example, those businesses in the UK that have a Value Added Tax (VAT) payment due in the second quarter (April to June) of this year have the option to defer that liability payment until the end of this financial year (March 2021). Income tax payments of the self-employed can also be deferred by six months until January 2021.

While the deferral of these tax payments will improve the cash flow positions initially, transactions in the UK National Accounts are recorded on an accruals basis. These are registered at the point when the liability was adjudged to have taken place, rather than when the tax payments are paid on a cash basis. That is, these accrued receipts are recorded as taking place over all the relevant months of the financial year, reflecting the period during which the liability arose[6].

As such, there should be no impact in the non-financial account from the shifting of tax payments. There will be offsetting impacts in the financial positions for government (financial asset) and corporations (financial liability) in accounts payable and receivable. However, it is likely that some deferred payments will not be paid because some firms and unincorporated businesses will fail between now and the end of the financial year. If so, either debt forgiveness or a debt write-off is recorded.

In addition to tax deferral schemes, some payers will be eligible for a business rates holiday, meaning they will be exempt from paying this tax for one year.

Trade Credit Reinsurance Scheme

Trade credit insurance provides cover to business-to-business transactions, insuring suppliers selling goods against the company they are selling to defaulting on payment. COVID-19 has led to businesses experiencing financial difficulties, which has increased the likelihood of credit insurance withdrawals or substantial premium increases. This Trade Credit Reinsurance Scheme is aimed at maintaining the majority of trade credit insurance coverage in the UK by providing support to the insurance industry.

This intervention is likely to see the position of financial corporations and PNFCs – that is, those covered by trade credit insurance – affected to a smaller degree than they would have been in the absence of this policy. The position of the central government and financial corporations would then reflect the new interactions between those institutional sectors.

Notes for: Recording of fiscal and monetary policies

1. Further information on the direct fiscal consequences of unconventional monetary policies has been produced by the Office for Budgetary Responsibility.
2. Updated figures by the Office for Budget Responsibility show that PSNB would rise to 15% of GDP in the financial year ending 2021 in its reference scenario. The Resolution Foundation estimates that PSNB would be 11% this year under its three-month scenario. The National Institute for Economic and Social Research forecasts PSNB to be 10% this financial year.
3. The Coronavirus Future Fund has also been introduced, which provides government loans to UK-based companies ranging from £125,000 to £5 million, subject to at least equal match funding from private investors. These loans may be an option for businesses that rely on equity investment. However, there is no loan guarantee in place for this scheme.
4. The Bank of England has agreed to provide monetary finance directly to the government through a temporary extension of the Ways and Means facility.
5. Further information on the CJRS and SEISS is now available, which explains how the job retention schemes will operate in the UK and so how these transactions will be recorded in the UK National Accounts.
6. There will also be an effect on VAT receipts from any adverse impact on the UK economy.

5 . Practical challenges

Early estimates of non-financial and financial transactions are subject to data revisions, reflecting the inherent trade-off between timeliness and accuracy. As we incorporate more comprehensive information from a wide range of surveys and administrative records, those initial estimates are revised.

Recent analysis has highlighted the compilation challenges we expect to face in producing the UK National Accounts, including that it is likely the data content of these early estimates will be lower than typically is the case. Those challenges that relate to imputation and forecasts are as pertinent in how we compile the UK Institutional Sector Accounts, as early indications show a fall in the response rate to a wide range of our financial surveys.

We will endeavour to produce the best estimates possible, including those for the package of interventions that have been introduced, given these practical constraints. We will focus resources on the main transactions, including reviewing the extent to which our traditional data feeds pick up the expected impacts of these policy interventions and looking at alternatives for how this information can be collected.

There may be challenges around estimating the accruals treatments of government receipts. External indicators will provide further insights on how financial markets are responding and how these movements might be affecting financial transactions, particularly as gross flows may be more volatile and there may be marked changes in the sectoral behaviour. We will look to collect wider intelligence where possible, reflecting this in our producing reconciled estimates of the UK Institutional Sector Accounts.

There are two production challenges that will require further consideration.

It is possible to estimate the net lending or borrowing positions from the non-financial accounts and the financial accounts. In theory, the net position on non-financial accounts matches the net position on financial accounts. Given how these are compiled in practice, this conceptual equivalence is a challenge when compiling this feature of the UK Institutional Sector Accounts. There will typically be a statistical discrepancy that reconciles these estimates. Given the current production challenges, it is possible that this statistical discrepancy will be larger than normal reflecting the expected lower data content, particularly on the financial transactions.

The balance sheet positions not only reflect financial transactions that take place within a period, but the exposure to potential revaluation effects and other changes in volume that impact on the closing stock position, such as debt write-offs. As financial assets and liabilities can be denominated in different currencies, exchange rate movements can impact upon the value of the stock position, which is recorded in the domestic currency. The market values of external assets and liabilities arise from changes in market prices of financial assets, such as equity and debt traded on stock markets. Exchange rate and price movements have been particularly marked in response to COVID-19, so there may be additional challenges in producing reconciled flows and stocks for households, corporations, government and the rest of the world.

6 . Conclusions

The coronavirus (COVID-19) pandemic is having a significant economic and financial impact on UK households, corporations and government. We have reflected on some of the developments that have taken place so far, which we will continue to monitor, including the large fiscal and monetary policy response. The Office for Budget Responsibility has produced a comprehensive overview of the fiscal policy response so far, including initial estimates of the costs of these interventions.

The UK National Accounts provide a coherent framework to assess these impacts. We have looked to explain how we might expect estimates of non-financial and financial transactions to be affected, including on important economic indicators. This includes the net lending or borrowing positions of households, corporations, government and the UK in relation to the rest of the world.

It is important to note that we do not consider the likely effects highlighted here as forecasts, nor have we provided an exhaustive list of all the effects that will be experienced. Instead, we have highlighted some of the possible effects we might see in response to COVID-19, explaining some of the main channels through which the UK economy is likely to be affected. We will provide a more informed picture of the effects when the UK Institutional Sector Accounts are published.

National Statistical Institutes (NSIs) are facing significant practical challenges in compiling the Institutional Sector Accounts, which may lead to higher levels of uncertainty. We have explained some of the steps that we are taking to help better understand and, where possible, tackle these challenges. We will continue to work with other NSIs and international organisations in looking to implement best practice in response to these challenges. The compilation of these estimates will be monitored closely, as we look to ensure that we are able to capture these effects.